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THE MONEY MUDDLE
AND THE WAY OUT

By the Same Author

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(George Allen & Unwin)

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UNEMPLOYMENT

(Oxford University Press)

THE NATIONAL DEBT

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THIS GOLD CRISIS

(Victor Gollancz)

THE MONEY MUDDLE
AND
THE WAY OUT

by

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Financial Secretary to the Treasury
(1929-1931)*

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MONETARY POLICY

“THE aim of British monetary policy should be to stabilise wholesale prices at a suitable level in this country and to seek by international¹ agreement the largest practical measure of stability in the rates of foreign exchange.”

Extract from Resolution carried unanimously by the Labour Party in its National Conference at Leicester, October 1932.

“That this Conference would deprecate any attempt to return to the gold standard in the near future, and urges that His Majesty’s Government should consult with the Dominions with a view to stabilising the purchasing power of money, within the Empire, on the basis of an index-scale of wholesale commodity prices.”

Resolution carried unanimously by the Conservative Party in its National Conference at Blackpool, October 1932.

PREFACE

To write a book on currency reform used to be regarded as the sign of a crank. All proper-minded people knew that the high priests of finance acted on inspired tradition and that to question the wisdom of their judgment was heresy. But, to-day, as a result of the world crisis, these lordly ones have fallen from their high estate and heresy has become not only permissible but even fashionable.

Critics are found in every walk of life and include employers and workers, politicians and scientists, economists and even bankers. Recognising that sound finance is essential to world recovery, their criticism is mainly directed to the failure to stabilise the purchasing power of money, or even to prevent violent changes in prices. This view finds expression in the two resolutions carried unanimously by the Labour and Conservative Parties in their respective Conferences in 1932. On the previous page will be found the texts of these resolutions, which both demand that the price level should be stabilised.

In view of this surprising unanimity, supporting opinions I have long held and advocated, I have tried to construct a workable scheme which would achieve the desired object; and this book is the

result. It is not of course wholly new. Others as well as myself have outlined similar proposals elsewhere. But in this book I have endeavoured to give them a new form and to present them with greater definition. If then after examination the scheme be approved there is no reason why it should not be adopted. If, on the other hand, it be found faulty it can be amended or scrapped. But in any case the degree of precision which I have tried to impart into the discussion should help towards the ultimate solution of this vital problem.

The book is written more for the general reader than for the expert; so, though I have not shirked difficulties, I have avoided as far as possible technicalities. I am aware of course that the success of any monetary policy must ultimately depend on the knowledge and skill of the experts who have to work it. This entitles their views to respect, but it does not deprive the public of the right to lay down the general direction of policy, any more than an owner of a motor car in entrusting the driving to his chauffeur forfeits his right to choose his destination. But when an owner buys a new car he is entitled to assurances from the salesman that the car if properly driven will serve his purpose. Such assurances I have tried to justify in this case.

I hope no one will imagine that the scheme here

outlined is a panacea for all human ills. I certainly do not so regard it myself. On the contrary, I believe that our present organisation of society has many glaring defects, all of which require treatment and some of them treatment of a most drastic kind. But it has seemed to me possible and advantageous to isolate one defect of a fundamental character which is blocking all progress and to point the way to a remedy which cuts across present political controversies and is therefore capable of being adopted at once by common consent.

Some of those who share my political faith that a planned economy must be extended to fields other than finance if it is to provide a complete cure for our present economic disorders may dissent from the emphasis that I place on this particular question. Some may even regard my scheme as likely to postpone a wider reform and therefore as definitely unwise. My own view is that on the contrary it is essential to lay the foundation of a sound financial system, and that on that it will then be possible to build whatever superstructure of economic life society may deem best.

In ordinary times men fear change. What was good enough for their fathers they are content to continue for themselves. If therefore these were ordinary times proposals for change in the basis of

finance would be looked at askance even if they were looked at at all. But these are times when the condition of the world is desperate and every day becomes worse. It is almost universally recognised that fundamental changes must be made if human society as we know it is to survive. I have therefore written this book in the confident belief that it will receive careful examination and that if it survives the test it will contribute in some degree to restore prosperity to the world.

F. W. PETHICK-LAWRENCE

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THE MONEY MUDDLE AND THE WAY OUT

CHAPTER I

THE DOWNFALL OF CIVILISATION

IN Greek mythology the gods were believed to laugh at the muddles of mankind. If that were true there can never have been a time in history when their merriment was more boisterous than to-day. For it is almost inconceivable to construct a situation more ironic than that in which we find ourselves.

The essential facts are not really in dispute. One by one the lights of civilisation are being put out. Science, Art, Education, and Public Health are being curtailed, and luxuries, comforts, and even the necessities of life are being dispensed with. What we held yesterday is lost to-day, and what we have to-day is expected to be gone to-morrow. This is happening not in one country alone but in nearly all the countries of the so-called civilised world.

Now if the earth were becoming unfruitful, if man were losing his power to produce, if population were outrunning the area of supply, the tragic facts would at least be intelligible. But everyone knows that the exact contrary is the case. Ever since the days of Adam men and women have been struggling to find

out how to produce enough in a day's work to satisfy the day's needs and to have something over. At last they have won through, but the hour which marks their victory marks also their discomfiture. It is as though they were struck down with an unaccountable paralysis which prevents them from enjoying the fruits of their success.

It is important that we should be quite clear about the facts, for there are some people who tell us that what is wrong is simply that machinery has ousted men, and that in consequence the world is satiated with products and men reduced to idleness. It is possible that at some future time the world may reach a condition of which this will be a true description. If so, when that time comes it will be necessary to organise man's leisure so that with his bodily needs already satisfied he may develop his mental and spiritual life.

But it is certainly not a true description of the world as it exists now. For to-day there is no sufficiency of production, and what there is is being steadily reduced.¹ In every country there is shortage of many of the elementary amenities of life such as house room, clothing, and opportunities for health-giving recreation; while in many lands there is dire want of the bare necessities of life, so that men and

¹ It is estimated that industrial production in the United Kingdom, United States of America, France, and Germany has been curtailed since 1929 at the rate of 12 per cent per annum.

women and children are literally dying for lack of food. The engines of production are available, the men and women who could work these engines wait in readiness, but though the products are eagerly desired the engines remain unused and their human ministers unemployed.

It is not even true to-day that any considerable section of the community is benefiting from what is taking place. In the earlier stages it may have been so. A few gained while the many lost. But to-day so universal is the declension that workers and workless, employers and shareholders, tenants and landlords, and even rentiers and financiers are becoming engulfed in the common ruin.

This state of affairs is so utterly preposterous, so contrary to the most elementary ideas of man's intelligence, to say nothing of his humane instincts, that we are almost tempted to attribute it to some supernatural spell or to say with the French philosopher that "of course the Universe needed a madhouse and it is to be found in this planet." But if in this twentieth century we refuse to accept any such fanciful hypothesis, it behoves us to discover the true origin of our misfortunes and having found it to set to work at once to remedy them.

The cause we are to look for must be great enough to account for the magnitude of the disaster, it must be sufficiently widespread to account for its universality, it must be of such recent growth that it provides an explanation for the new turn which

events have taken. All these conditions would be simultaneously satisfied if we were to find that during the last few years what we had been doing was nothing less than to act in defiance of one of the fundamental concepts of civilisation.

CHAPTER II

STANDARD UNITS

THE continued existence of all terrestrial life, as we know it, depends on certain elements of stability. Living creatures can adapt themselves to changes, but those changes must not be too sudden or too great.

Thus, though life can be sustained at various temperatures between certain limits, prolonged exposure to heat or cold outside these cannot be endured, and even within the limits sudden changes are likely to be fatal. Again, while creatures such as fish can live under widely different pressures rapid increase or reduction causes death, and within much narrower limits man suffers acutely when atmospheric pressure is altered. We walk over the ups and downs of the solid earth without difficulty and without discomfort, but on shipboard when the deck rapidly changes its inclination our balancing mechanism registers acute distress and often causes what we call "sea" sickness.

On the basis of this natural order man has erected the complicated edifice of civilisation, the cornerstones of which are certain further elements of stability. If any of these corner-stones be displaced, it is not unnatural to anticipate disaster to the whole superstructure.

Among these elements of stability are the standard units of length, weight, and volume to which we are so used that we never pause to think how badly we should fare without them. Suppose, for instance, there was no yard measure, and no other recognised unit such as inch, foot, mile, or metre. How terribly complicated would become the life of the engineer, the carpenter, the builder, to say nothing of the housewife planning the equipment of her home! And we should be little better off if there were a yard measure but its length was constantly changing.

A woman goes to a shop to buy a length of material for domestic use. The shop assistant measures it out for her behind the counter. Suppose when she gets it home it is not the length she asked for, and suppose that this turns out to be due to the man having tampered with the brass rule by which he measured it. Suppose, further, that this tampering were to go on all the time at all the shops in the country. Shopping would be thrown into confusion.

Now examine the matter from a slightly different angle. Suppose a shopkeeper buys a roll of a thousand yards of cloth and proposes to sell it retail in one thousand pieces of one yard each. Suppose that between his purchase and his sale a considerable time elapses and that during that time the length of the yard substantially increases; quite clearly all his expectations of profit will be disappointed because his roll will cut up into less than a thousand pieces of the length of the new yard. Conversely, if

the yard is decreasing he will make an unexpected and illicit profit.

Precisely similar results would follow from changing standards of weight or volume. An increasing pound weight or pint pot would mean disappointed and ruined traders; and decreasing standards would mean disappointed customers and improperly enriched traders. Nor would it solve the difficulty to meet changing standards by a continually adjusted price list, which could only lead to endless confusion and abuse.

It is for this reason that in every civilised country a rigid system of weights and measures is enforced. Standard lengths and weights are carefully preserved and any departure from these standards is severely punished. In many countries it is even provided that all selling must be in accordance with them and that selling, say, by the packet of undeclared weight is liable to punishment.

It is not everything, however, that is sold by weight or measure; but every transaction except those where pure barter is employed involves the use of money. Therefore the unit of money is still more important than the units of length, weight, or volume. Moreover, as very many transactions involve the element of time, lack of stability in the unit of money over a period of time is likely to be more subversive of ordered life even than instability in those other units.

An almost infinite number of examples of the

injury wrought by an unstable unit of money can be given. A landlord leases a house to a tenant for a period of twenty-one years at an annual rent of £100. When this contract is made there is an implied assumption in the minds of both parties. Each imagines that he knows what £100 means not merely to-day but during the whole period for which the contract runs; and the natural assumption is that it will have (roughly, at any rate) its present purchasing value. Now suppose that that assumption is rudely upset either by the purchasing power of the £100 sinking almost to nothing or by its rising to many times what it is at present, then one or other of the parties unexpectedly and grievously suffers while the other is correspondingly enriched.

Suppose that a farmer buys a farm and it is decided to leave £5,000 of the purchase price on mortgage at 5 per cent. He agrees to this in consideration of the fact that the annual interest of £250 which he will have to find is, say, about one-quarter of the value of the gross produce of the farm estimated at the date of sale as £1,000 a year. But if during the continuance of the mortgage the purchasing power of money so changes that the same gross produce will sell either for several thousand pounds on the one hand or for only two or three hundred pounds on the other, he will be able lightheartedly to discharge his mortgage or be brought to bankruptcy as the case may be.

The worker starts work on a Monday morning at

an agreed wage on the tacit assumption that there will be no serious change in prices between that day and the Saturday when he receives his money. Over so short a period the assumption is generally justified. But sometimes the wage contract runs for a much longer period or it may be understood that there will be no change without long notice. The worker whose wage is called a salary always contracts for much longer terms, and for civil servants and some others the term is even for life. In such cases reasonable stability of the money unit is always implied in the contract, and if in the sequel facts do not accord with this assumption one party or the other will have good grounds for grievous complaint.

Take next the case of a dealer who is in the habit of buying goods in bulk and disposing of them in the course of a few months. Suppose that he reckons on a small margin of profit, say 3 per cent, on the basis of the price levels that exist at the time of his purchase. If prices rise generally between purchase and sale his 3 per cent may be swollen to 5 per cent or 10 per cent, and if they fall it may be turned into a loss. Such gains or losses will appear all the greater if, as is often the case, such dealers are trading partly on borrowed money.

When prices fall the manufacturer is doubly hit. First, he suffers while they are in the act of falling. Secondly, when they have come to rest at the lower level he finds himself in further difficulties. The latter, or static, loss is the only one that is generally

recognised. Let us suppose that in normal circumstances a manufacturer operating on a quantity of raw material costing £1000, with labour costing £1,000 and overhead charges (rent, bank interest, debenture interest, etc.) reckoned at £500, is producing finished product selling at £3,000 and making therefore £500 profit. Suppose that prices fall all round to half their former level. His raw materials now cost £500 and his finished product sells for £1,500, but overhead charges remain at £500, and even if wages were to fall to half what they were before. i.e. to £500, the whole of his profit would vanish. When it is borne in mind that rents and retail prices fall far slower than wholesale prices, so that the wage-earner will rightly fight fiercely against cutting his wages in half, it will be seen how difficult is the problem of "adjustment" to a lower level of prices.

But there is still the dynamic loss to be considered. Two illustrations may be given. A manufacturer decides to install machinery which he purchases with £1,000 borrowed from his bank at 5 per cent. At the end of a year similar new machinery can be got for £900, so that in addition to normal depreciation and the £50 paid to his bank, he is a further £100 to the bad. That is to say, his real rate of interest is not 5 per cent but 15 per cent, and so long as prices continue to fall he will go on suffering in this way.

Take in further illustration a man working a

process which takes six months to turn out the finished product. Suppose that he anticipates, calculating on the existing price level, to make a profit of 5 per cent. Then a general fall in prices at the rate of 10 per cent a year will wipe out his profit; and a greater rate of fall will turn it into a loss.

No amount of "adjustments" will neutralise this dynamic loss, which will tend to paralyse manufacture while the price level continues to fall. So long, therefore, as it is expected to continue to fall, the dealer will refuse to deal, and the manufacturer will refuse to install new machinery or to make for stock. For, as it is popularly said, no business can be done on a falling market.

It only remains to add that these illustrations of the effect of the changing value of money in terms of purchasing power are not fanciful pictures of an imaginary world. They have been the terrifying experiences of the last eighteen years, starting in 1914. All countries went through a period when the unit of money bought less and less. In March 1920 the English pound got down to a purchasing power in wholesale goods of less than one-third of what it had had in 1913, and the American dollar to about two-fifths of what it had been in that year. All this time manufacturers and traders made roaring profits and creditors were happy. In mid-Europe the process was carried so far that the mark and the krone became valueless and the debtor was completely relieved of his debt.

Then the reverse process set in. The unit of value stopped going down and began to go up. It has gone on going up in this country, with one or two slight breaks, ever since. To-day (December 1932) the English pound will buy between three and four times as much in wholesale goods as it bought in March 1920. In America the dollar has had, flanking a period of stability, two periods of rapid rise. To-day it will buy in wholesale goods two and a half times what it could in 1920. In nearly all other countries¹ there came a turning-point where the unit of currency ceased to fall in value and went up and has gone on doing so until to-day.

These facts are indisputable. Nowhere in the last eighteen years has the unit of value remained stable. Its instability has far exceeded anything experienced before. What reason can there be to doubt the connection between the present world disorder and this new disturbing influence which is contrary to one of the essential concepts on which the whole of civilised life rests?

¹ Except Russia, which rests on a different economic basis.

CHAPTER III

COULD ALL PRICES BE FIXED?

THE last chapter was devoted to exploring the disastrous consequences arising from instability in the basic units and in particular in that of money, the unit in terms of which value is measured. In the present chapter the search for a remedy will be begun.

Standardisation of the units of length, weight, and volume presented considerable difficulty in the early days before strong Central Governments came into being; but now it is only found necessary to keep in some central place the authentic standard and to compel everyone else within the country to employ an exact replica of it for all purposes of measurement. Then whether the length to be ascertained be that of a field or a house or a carpet or a coat, it will be reckoned in terms of the yard or its fractions in the British Empire and in the U.S.A. and in terms of the metre in most other parts of Europe and America. Similar methods apply to weights and volumes. Some trouble of course is experienced in passing from one country to another where different standards are used, but it is only necessary to know the fixed proportions between them to be able to make the necessary adjustments.

When, however, we turn to the measurement of

values we are at once engulfed in a sea of troubles. Not only is there no fixed relationship between the standards of one country and those of another, but inside a single country the measure of every article is constantly changing. A ton of iron, a bushel of wheat, and a pair of boots vary in price from month to month and their prices also vary in their relationships to one another.

How convenient it would be for trade if this were otherwise! What an immense saving in time, in ink, and in temper would result from the establishment of a fixed price list for all articles! There would be no need to write or ring up to inquire the cost of anything; the buyer would consult the permanent list and give his order, knowing exactly what he would be called on to pay. The manufacturer's only anxiety would be to see that his costs of production were within the difference between the permanent price of the finished product and that of the raw material.

Alas! This dream of "trade without tears" is very far from realisation—so far that for practical present purposes it may be regarded as altogether impossible. There are many reasons for this. Probably the first that will occur to the reader is that there are any number of different grades of a particular article. Apples are of many qualities; there are prime and inferior cuts of meat, and all sorts of leather; some kinds of wheat are much better than others; while what comparison could there be between a Paris

model gown and ready-made clothing? But, strange as it may seem, this difficulty could to a large extent be met. Even to-day in certain wholesale markets—for instance, those of wheat and wool—one quotation is all that is required. It is understood that that applies to a certain carefully specified grade, and the price of other grades can be worked out from that on certain known rules. If, therefore, the price of the standard grade could be permanently fixed the prices of the others would automatically be fixed also. Most of wholesale trade could be dealt with in this way, and with wholesale prices thus standardised retail prices would largely follow suit.

But a second difficulty occurs to the mind. What about geographical distribution? Can there be a fixed price regardless of the cost of transit? But this difficulty is of even less substance than the first. For the precious metals and other articles of great value and negligible bulk the price is almost independent of location. For other articles of international commerce the quotation given is understood to refer to a special place. For instance, it may be f.o.b. (i.e. *free on board*), and transport¹ has to be added. Or the quotations may be for the goods “on rail”; and the prices for any particular place have to be worked out from these. Of course, therefore, there must be differences in the price of a ton of coal at the pit’s mouth, on rail, at the London depot, or delivered

¹ Tariffs have of course also to be taken into account in cases where they exist.

in sacks to the customer's house. But such differences would not conflict with the principle of having a price which in each locality remained steady over a period of time.

The real difficulties are more subtle and more obstinate. How is it possible to keep the price of any and every article unchanged as time goes on, when all the other circumstances of the case are changing all the time? There is the seasonal difficulty in the case of perishable goods; for a pound of ripe cherries or a dozen new-laid eggs on June 1st are quite clearly of different value from similar articles on December 1st. There are new discoveries making the source of supply of some articles far more abundant. There are new inventions making the process of some manufactures far more easy. There are new demands pressing harder and harder on the limited supply of certain raw materials. These are some of the factors which to-day are reflected in changing price levels. If prices were all to be rigidly fixed without making any other fundamental change in our economic system complications would very soon show themselves.

What would happen, for instance, if the number of customers anxious to purchase an article at the fixed price exceeded the supply of the article? The only answer is that some of them would go short, and unless supply quickly caught up, queues would develop as they did in the early days of the war. The Government might meet this by rationing. But

there are not many peoples who will tolerate rationing of a wide range of articles in peace time, and illicit trading at higher prices would be likely to develop.

On the other hand, if discoveries and inventions are such as to enable an article to be produced with a larger and larger margin of profit to sell at the fixed price, manufacturers would turn it out in increasing abundance and great quantities would remain unsold. The Government could not force people to buy more than they were willing to do at the fixed price, and again illicit trade would occur, this time at prices lower than those officially fixed. In fact, queues and gluts and illicit trade are the natural outcome of trying to fix the individual price of every article under our existing economic system, and sooner or later the price-fixing would break down.

Of course under a complete Socialist system such as exists in Russia to-day the control by the Central Government of the price of individual articles is very much greater. But even in such a country the Government is not very likely to wish to retain unchanged indefinitely the prices of a number of articles at their old levels when some of them can be produced much more easily than before and others are so greatly in demand that the supply has run short. Even there, therefore, an unchanging price for each and every article is impracticable and unlikely.

Is it then hopeless to try to secure a stable unit of

value and must the quest be abandoned? Not yet. There is one avenue of approach which has not been fully explored. While it may be impossible to fix the price of each and every article it is possible to fix the price of one article singled out from the rest. Because if money has no other attachments we can so define the monetary unit that it shall be the price of a given quantity of the article so selected. Then whatever be the supply of or demand for the particular article, whether it be produced easily or with the greatest difficulty, the unit of money which measures its exchange value will remain clamped to it.

Primitive agricultural communities learnt this long ago, and a single head of cattle was selected as the unit of value. In terms of this unit the value of other things was measured, so that when a wealthy tribesman took to himself a wife his purchase money for her consisted of so many head of cattle. This practice continues up to the present day in some parts of the world.

Town dwellers, however, soon found that a cattle unit was not a very suitable one for them and they preferred to tie their money up to something more tangible. A standard weight of iron, copper, silver, or gold served at different times for the standard unit of value. Under this system, which still flourishes in several countries, the price of any other article is a certain amount of the chosen one of these metals, which has to be weighed out to effect the purchase.

Of course the amount required to buy any particular article varied from time to time, but so long as life went on in customary ways the variations were slight and gradual and it almost seemed as though there was a fixed price for everything.

The change over to coins of the selected metal involved no essential difference, for the coins were merely units of standard weight and guaranteed fineness. A further change took the form of not insisting upon physical transference of the metal and accepting instead a promise written on a piece of paper¹ to effect the transfer when required. Bank notes and cheques thus came into being and proved of great convenience, but essentially the principle was unchanged.

Meanwhile, however, all sorts of discoveries and inventions were being made which completely altered the customary relationship between one article and another, and as a result there was no longer even an approximate steadiness of the prices of individual articles. Further, people began to sell intangible things such as title deeds, shares in businesses, and even claims on the Government or Local Authority. The prices of such "securities" have proved even more unstable than the prices of physical goods.

¹ Or on metal coins of other than the chosen standard, which thus acquired a face value in excess of their intrinsic value. In this way the silver shilling in 1930 had a face value of several times its intrinsic value as silver, which was only a few pence.

Then there came a day when some of the banks and Governments who had given promises to transfer coins when required failed to fulfil their promises or withdrew them, and the pieces of paper on which their promises were written became accordingly unrelated to any physical unit. But because they were declared by the Government "legal tender" and because they were the only means of effecting purchases they continued to be recognised as of value. In England shortly after the war and again to-day (January 1933) the pound sterling is broken away from its gold anchorage, so that whereas before the war and again from 1925 to 1931 while the pound was clamped to gold, half an ounce of gold cost about two pounds, it now costs about three.

In Germany during the middle 'twenties the paper mark fell much more violently, and so rapid was its fall that the people had occasion to make new units of value in terms of which to effect their transactions. Strange as it may seem, butter was at one time used as a unit and other articles were sold for so many pounds of butter! Of course the butter was not passed from hand to hand or put into purses or banks ; the requisite number of paper notes equivalent to its price were employed for physical transference ; but it was a pound of butter all the same that was the real unit of value.

At the present time many different practices prevail in different countries. But none of them is proving satisfactory. Many people are asking what

is the best policy for England and for the rest of the world. It has been shown in this chapter that it is not possible to fix the price of each of a number of different articles but that it is possible to fix the price of one selected article by linking up the unit of value to that. Is there any one thing to which it is desirable to link it? And if so, what should that one thing be?

CHAPTER IV

A BASKETFUL OF GOODS

IT seems at first sight very unlikely that the search for some new thing, more suitable than any that has been tried before to represent the unit of value, will be successful. Human experience has no help to offer. Only a little while ago it was assumed that gold was the last word in the matter. Yet to-day England is off the gold standard, and most people recognise that it would be a mistake to return to it. It is hard when gold has failed to think of anything else better. Yet unless mankind can discover some better thing civilisation, already economically sick with the rolling and tossing of the price level, bids fair to be wrecked altogether.

Light begins to dawn upon our difficulty when we realise that the thing we are looking for need not be a simple article but might be a composite entity. Thus it would be possible to select a bar of metal consisting of so many parts by weight of gold and so many parts by weight of silver. Some people to-day definitely favour this actual proposal. If it were adopted there would be a varying price for gold in terms of this unit and a varying price for silver, but the combined prices of quantities of gold and silver in the correct proportions would remain constant. This proposal presents no practical difficulty, but

unfortunately it would go only a very little way to solve our problem, for there is no ground for thinking that the prices of other articles such as wheat, wool, cotton, rubber, machinery, houses, clothes, and still less that those of stocks and shares, would necessarily be much more stable in terms of the new unit than in terms of one of the old ones.

Before carrying the idea to the next stage let us examine a little more closely what it is precisely that we want to find. Phrases such as a "stable unit of value," a "uniform level of prices," a "constant purchasing power for the currency" are all very well in popular parlance, but if some definite action is going to be taken with regard to them they must be defined more closely. There is no doubt that the intended meaning of all of them is roughly the same. It is that a person in possession, say, of 100 units of currency (pounds in England, dollars in America, francs in France) and setting out to spend them on the kind of things on which he usually spends his money will find that he gets roughly the same quantity of things for it to-day, next week, next month, next year, and even twenty years hence.

Let us take as the simplest case that of a woman going to market to spend the week's wages. She returns later with her basket filled. Some weeks afterwards, she goes out on a similar errand with the same amount of money. It may be that meat and bacon are up in price but that tea has remained the same and butter and eggs are down. If she just

succeeds in filling her basket with the same quantities of the same things with the same amount of money she will say that, taking one thing with the other, there has been no change in the price level.

Suppose now that the thing to which the unit of value is to be linked is this basketful of goods, then however much the individual articles in the basket may change in price, the price of the whole of them taken together in the proportions in which they were in the original basket must remain the same. Here then is apparently the solution of the problem. But before we throw our hats up in the air and congratulate ourselves on our discovery we have to make sure first that the solution is theoretically complete, and secondly that it is practicably possible.

It may be that so far as the particular woman is concerned, and so far as her particular shopping in the particular town in which she lives is concerned, we have succeeded in reaching a stable unit of value. But what about her other expenses such as her clothes, her rent, her doctor's bill, and her summer outing? What about some other woman living in some other town whose weekly basket is somewhat differently composed? What about some other family with an entirely different income? What about a manufacturer whose purchases and sales are concerned with an entirely different range of articles? Are we entitled to assume that the solution we have discovered will equally satisfy the condition in these other cases? If not, can we find some typical "basket

of goods" which will completely or even roughly meet all the cases; so that by pinning the unit of value to that they will all be fairly satisfied that there is no serious change in the purchasing value of their money? The discussion of these problems will be reserved for the next chapter.

But even when we have dealt with this difficulty there will remain the further important question as to how to give practical effect to the theoretical solution which we have found. For we have travelled a long way from the original idea of the "one thing" to which the unit of value is to be attached from the days when it was a single substance like cattle or gold. It has now become a basketful of goods.

When cattle pass from one ownership to another, when gold coins are paid by the purchaser to the vendor the equivalence of the unit of value with the one thing is physically apparent. Even when the currency consists of paper, it may be comparatively easy for the central bank to hand out (so long as the supply lasts) gold coins or gold bars or even mixed bars of gold and silver in exchange for paper bank notes when requested to do so. But it is clearly impossible for baskets of miscellaneous goods to pass from hand to hand in daily discharge of debts or even for the central bank to keep stocks of such baskets ready to hand out to all and sundry when they bring bank notes. In banker's jargon there can in fact be no question of direct "convertibility" of the currency into baskets except in the ordinary way

of trade. If, therefore, the unit of currency is to be firmly tied to the group of things in the basket it can only be by indirect means, the character and efficacy of which will need careful exploration. To this some of the later chapters of this book will be devoted.

CHAPTER V

THE CONTENTS OF THE BASKET

MANY of the things which are now taken for granted as the commonplaces of everyday life were originally regarded as quite unworkable. The motor-car and international postage may be quoted as typical examples. While they were being invented the complications seemed overwhelming. To-day when they are running smoothly the man in the street wonders how their success could ever have been in doubt.

It is just the same here. Complications no doubt there are, but they can all be dealt with. There is first the decision as to the contents of the basket. This involves the choice not only of articles but of quantities. This choice would be very simple if there were only one single individual—a woman going marketing—to think of. It would consist of all the things she buys in the year in the proportion in which she spends her money on them.

But as the “basket” is to serve for other people as well, other things will also have to be included. The most comprehensive choice would cover everything which is bought for money at the present time such as food, drink, clothing, tools, machinery, all sorts of raw materials, ships, lands, houses, and even house rent, railway and tram fares, and seats in

theatres and picture palaces; while some people might wish still further to add stocks and shares and the price of foreign exchange.

Of course no physical basket could hold all these things, and even if the term is only used figuratively the list is far too extensive and complicated. It is proposed, therefore, to select a number of staple commodities which between them cover a fairly wide range and may be regarded as representative of various classes of goods. One of these would be wheat, another wool, another iron, another meat, and so on. And the proportions would be those in which the classes of things they represent are purchased at the present time. Stocks and shares would be excluded as unsuitable. The final selection would be made by an expert committee acting under Government instructions.

There is nothing very new or difficult about such a selection. Economists have long been in the habit of selecting suitable articles, choosing appropriate quantities of them (or *weighting* them as they usually express it) and working out the aggregate price over a period of years. These they have called "index numbers." Then by reducing the index number for a standard year to 100, they have been able to express the index numbers for other years as percentages of that.

The method would be precisely the same here. But the object would be different. Their object has been to measure the *instability* of the price level by

noting the changes in the index number. Here the object would be to secure the *stability* of the unit of value by linking it to the composite price (corresponding to the index number) of the selected group of articles. In other words, the object would be to keep the composite price of the group fixed. How to do this will of course have to be considered later.

It is possible that at this stage readers will be inclined to wonder whether the modifications already made in what was once a basket of market goods, but which has now become a group of staple commodities, has affected the virtue of the original idea. Their question really amounts to this: "Granted that it would be an advantage to a working woman if her week's marketing always cost her the same amount of money, granted equally that a business man would gain enormously if the average price of the things in which his transactions occur was always the same, are either of these desirable results brought much nearer by selecting a group of goods, not exactly her things and not exactly his things, and keeping their composite price constant by equalising it to the unit of value?"

To this question I have no hesitation in answering with an emphatic affirmative. The staple articles of everyday use play so large a part in the lives of everyone who shares a common civilisation, and so interrelated are all human needs that if the price of a fully representative group of them be stabilised the price of another group is likely to be much more

nearly constant than if the unit of value be tied to a single substance such as gold. Anyone can verify this roughly for himself who has beside him the price lists of the last few years, for he will see that the principal articles have in general moved upwards and downwards together.

But the task of selection has not yet been finally accomplished when the choice of articles and of their proportions has been determined. There still remains a decision to be taken as to the stage in their production, from field or factory to consumer's house, at which their value shall be reckoned. This decision may be expressed shortly as to whether the selection is to be of wholesale or retail prices. There is something to be said for each point of view. The deciding consideration is the difficulty of selecting something which is subject, as retail prices are, to extensive local variations; and if the whole area dealt with exceeds the limits of a single country this difficulty becomes insuperable. It will be necessary, therefore, to select wholesale prices. But this selection will carry with it a large measure of stability in retail prices as well.

Doubt may perhaps be thrown on this by some people, who will recall the way in which wholesale prices rose faster and farther than retail prices from 1914 to 1920 and have fallen faster and farther than retail prices since 1920. But the connection between the two cases does not hold good, as a little consideration will show. The costs of the retailer are of

two kinds: (1) rents and other overhead charges and wages, and (2) cost of the goods which he buys to sell again. When the price of wholesale commodities is changing the former costs will show little or no change, the latter alone will be affected; he will therefore change his selling prices less than the change in his buying prices. But when wholesale prices are stationary so that the cost of the goods he buys remains steady, as well as the cost of his overhead charges, etc., the retailer will have no reason to change at all the price at which he sells retail to the public. There is good ground, therefore, for believing that (apart from the effect of changes in taxation) stabilised wholesale prices will bring stabilised retail prices at the same time.

The task of selection is now complete.¹ The choice has fallen on a group of wholesale commodities which may be regarded as representative of the goods which are bought and sold to-day. If the combined price of typical quantities of these can be

¹ The detailed selection must be left, as explained in the text, to an expert committee. But to help the reader to visualise the idea the following illustration is given. Suppose that the group were to consist of a bushel of wheat, a hundredweight of coal, a quarter of a hundredweight of pig iron, two gallons of oil, a pound of cotton, a pound of wool, four pounds of sugar, a quarter of a pound of tea, and five pounds each of beef and mutton. Then the £ would have to be controlled as explained in later chapters so as to be the wholesale value of all these things combined. In reality to secure the full advantages of the scheme the list would have to be considerably extended and the quantities correspondingly reduced.

kept steady the purchasing power of money will cease to be subject to the fluctuations which have thrown the various countries into confusion ever since the war began. Thereafter the man who rents a house or creates a mortgage or contracts a loan or agrees on a salary or makes any other money contract extending over a period of time will know that the intention of both parties at the beginning will not be vitiated by a vital change in the purchasing power of the medium of payment during the period that the contract runs. In other words, the assumption which he implicitly makes when he agrees to such contracts will for the first time have a reliable basis in fact.

CHAPTER VI

DISTURBING FACTORS

I WAS once on a boat in Egypt travelling up the Nile. It was held up for some hours by a difference of opinion between the management and the captain. When this was at last amicably settled the captain blandly remarked, "How dull life would be without these little disturbances."

That may be all very well when there is only at stake a few hours' delay of a boat, but when disturbances occur in the world's price level and throw the economic life of nations into confusion there is urgent need to minimise their effect with the least possible delay. The most serious causes of disturbances of this kind are international relationships, including under this general heading foreign debts, foreign trade, and tariffs.

In the ordinary course, international debts should be liquidated by the export of goods and by the rendering of services by the debtor to the creditor country. But if the debts be very large this may be impossible. The events in Germany in the early 'twenties will not be forgotten, when the mark fell and fell and German internal prices rose and rose. This was followed by the scaling down of the debt. No doubt other policies might have been followed in Germany at the time with different results ; but

if ever again an attempt be made to impose such an impossible debt on any country no carefully balanced system of regulating the price level is likely to be able to work satisfactorily in the face of such a severe external disturbing factor. The prosecution of another great war or a revolution would also put a strain on the price stability of a country which its Government would probably be unable to resist.

Let us turn from these cataclysmic happenings to more normal events. When two countries are both on the gold standard, and strictly carrying out its implications, their currencies exchange with one another at nearly a fixed rate. The same is true of two countries both on a silver standard. This fixity of exchange is an immense boom to traders, and if it could be secured between all countries at one and the same time as the stabilisation of the price level that would be an ideal solution. A tentative approach to this state of things was suggested at an international conference at Genoa as far back as 1920, but little has come since of the resolution that was then carried.

It is notoriously difficult to secure international agreement to take common action on such matters, but so vital is the question that a fresh effort ought certainly to be made at the forthcoming World Economic Conference to be held in 1933. If there then appear any grounds for believing that success is possible it will be worth while to make considerable modification of the plan in detail to secure it.

But it is essential that there should be common acceptance of the fundamental principle that the unit of value must in each country be linked not to one substance such as gold but to a group of things of a representative character. It will be necessary then for this group to be the same for all countries and to consist of articles which are the subject of international trade. Further, to secure uniformity the prices of these articles must be those at which they are sold on the high sea—that is to say, before tariffs have been imposed on them.

Assuming a satisfactory solution along these lines were to be reached, each country would have to be prepared to take such internal action as might be necessary to correct any divergence which might begin to show itself between its currency unit and the price of this group of international articles. The wholesale price level within the country of all articles, including this group and others of solely domestic production, would not then remain absolutely fixed but its fluctuations would be far less than at present, and there would be no risk of a continued trend over a long period of time in the upward or downward direction which is the bane of our present monetary system. The exchanges between different countries would vary little, as their currencies would all be linked to the price of one and the same group of international goods. Countries would of course have to balance their trading accounts with one another over long periods. But during short

periods they could use gold to settle temporary differences if these could not be arranged on purely book-keeping lines.

Such would be an ideal solution, but it is probably too much to hope that it will be adopted in the immediate future. If it is rejected it will not be possible to secure both price stability and exchange stability at the same time, and it will be necessary to fall back on a second-best solution. This would be for one country to decide to adopt the policy of linking its currency to a typical group of commodities, leaving other countries to pursue whatever policy seemed best to them. The disadvantage of this is of course that the exchanges will be free to fluctuate and to diverge. Naturally it cannot be expected that the currency of one country which is linked to a group of goods and the currency of another country which is linked to gold will preserve a stable relationship to one another.

So far as long-period changes in rates of exchange are concerned such countries ought not to try to prevent them; and tied as they would be to their respective standards they could not do so if they tried. But the point to notice here is that these changes will affect the prices in each country of the goods which are the subject of trade between them, and will have therefore a disturbing effect on the stability of their price levels. The methods of counteracting such disturbances will be considered in chapters vii and ix.

So far as short-period fluctuations in the exchanges are concerned the position is different. These fluctuations are greatly aggravated by the action of the speculators in exchange. There is unfortunately at the present time a body of persons who have control of enormous sums of money which they use to speculate in exchange movements, which they often tend greatly to aggravate. The tools described below—bank rate, credit expansion, Government activity—are far too slow in their action to be effective in combating these rapid speculations, and another tool is required. Such a tool has recently been fashioned by the British Government in the shape of the "Exchange Equalisation Account," consisting of a sum of no less than £150 millions. It is too early yet to be able to say whether this tool will be completely successful.

Closely connected with the international question is that of tariffs, which necessarily make the price level of goods inside a country different from what it is on the high sea. The general merits or demerits of tariffs are outside the purview of this book. But so far as upsetting the stabilisation of the price level within a country is concerned they will only enter as a disturbing factor when they are changed.

Another disturbing factor arises from the purchase of capital, including in this term not only the purchase outright of such things as houses and lands, but of working capital such as machinery, and of speculation in stocks and shares. These tend to

disturb the price level to-day owing to their irregularity and their consequent unequal employment of currency and credit. It is one of the beneficent results of stabilising the general level of prices that rapid fortuitous profits and sudden undeserved losses will be much reduced in extent and will happen much less often than under the present system. For they both arise to-day from sudden changes in prices, and innumerable examples of this could be given culled from the last few years. With steady profits, ups and down in prices on the Stock Exchange will also be much smaller and their demands on currency and credit on this account will therefore flow much more regularly. If there still remains some irregularity in them which causes disturbance it will have to be dealt with.

The only large remaining source of disturbance is change in productivity both of raw materials and of manufactured goods due to discoveries and inventions. This important aspect of the question will be best discussed in the course of Chapter IX, in which the working of the system will be described.

CHAPTER VII

TOOLS FOR CONTROLLING PRICES

THE disturbing factors referred to in the last chapter would be likely to wreck the scheme of stabilisation unless means were available to counteract their influence. These means consist of certain well-known tools which have been constantly used in the past to carry out the policy which the financial Authorities of the world had decided upon. Shortly described, these tools consist of expansion or contraction of credit and increase or decrease of purchasing power.

There are four principal tools. (1) The control of the currency; (2) the creation of credit; (3) the determination of the price of credit; (4) the furtherance of public enterprises on borrowed money. All these powers are derived from the central Authority (the king or the Government), but while some have been exercised directly by it others have been delegated to institutions called Central Banks. The precise demarcation between those used directly by the Government and those used by the Bank varies in different countries. From some points of view this distinction is very important, but for the purposes of this chapter it will be assumed that the Government and the Bank are acting in complete accord and pursuing a common agreed policy.

(1) The power to issue the currency was originally

exercised by the king, and coins stamped with his likeness were to the number and of the weight he decided. To-day in nearly all countries the principal part of the currency consists of paper notes, and while in gold-standard countries there is a promise to redeem these in gold if required, in most other countries the only *promise* of importance¹ is that they will be accepted in payment of taxes. But they are also declared to be "legal tender" and must therefore be accepted by any creditor inside the country if offered in discharge of a debt.

In old days kings sometimes "debased" the currency by reducing the amount of gold in the "sovereign." This had the effect of increasing prices. To-day a Central Bank by restricting the supply of currency has some power to lower prices, but if conversely it issues more currency than the public requires the coins or notes merely come back to it through the other banks, so that its power to raise prices by currency policy alone is slight. But currency expansion is a necessary concomitant of increase of credit.

(2) The fountain source of the creation of new credit resides in the Central Bank. Whenever it purchases securities in the open market it pays for them by creating a fresh credit in favour of the

¹ Bank of England £1 notes have printed on them the words "Promise to pay bearer on Demand the sum of One Pound." But as there are to-day no pounds other than these notes the words are quite meaningless.

vendor. If the vendor is what in England is called a joint-stock bank it can within certain limits build additional credit on the credit thus created. Conversely when the Central Bank sells securities the purchaser pays for them by reducing his credit at the Bank, and if the purchaser is in fact a joint-stock bank that will limit its power to issue credits to its customers. Reductions of credit reduce the purchasing power of the community and tend, therefore, to lower prices. Conversely expansions of credit, *if taken up and made use of*, increase purchasing power and tend to raise prices.

(3) The Central Bank of each country has also the power to decide what is known as "the bank rate." This is a rate of interest. It governs the rate of discount and also the rate which borrowers will have to pay for short-term credit. When this rate is put up they will be less inclined to borrow; and therefore the raising of the bank rate tends to restrict industry and lower purchasing power and therefore to reduce prices. Conversely a low bank rate¹ tends to encourage borrowers and to increase purchasing power and therefore to put up prices.

(4) Public enterprises financed by credit, whether undertaken by the Central Government or by Local

¹ The recent practice of joint-stock banks in England has been to fix a minimum charge for overdrafts, so that when this is reached no further reduction is made corresponding with a further fall in the bank rate. Such further fall, therefore, does not benefit borrowers except indirectly in so far as it affects the rate of interest on long-term loans.

Authorities, create new purchasing power and send up prices. Conversely when Governments or Local Authorities economise by cutting down their programme of public works the effect is to reduce purchasing power and lower prices unless private enterprise increases its own borrowing to the full extent that the public Authorities have reduced theirs.

To these four main powers should perhaps be added a fifth, which can only vaguely be described as "influence." Such influence is exercised by a Government when it issues patriotic appeals, and propaganda, to the public generally, and by a Central Bank when it makes its wishes known to the big financial houses with which it is daily in consultation. Such influence is particularly common in the dealings between the Bank of England and what is commonly known as the City of London, and by encouraging or discouraging internal or foreign lending may have a marked effect on the price level.

An illustration of the use of these tools in practice may be given by recalling what happened in various countries in the period immediately following the war. It will be remembered that during the war currency and credit had been abundant, and though bank rates were fairly high the overwhelming activity of Governments on borrowed money carried everything before it and prices rose. The same conditions continued to prevail in all countries for a further year up to nearly the end of 1919, with the

result that prices went on rising everywhere, trade and industry boomed, and unemployment was practically unknown.

After that divergent policies were pursued. In Britain a big drive was begun by the Bank of England with the definite object of bringing down prices and restoring the gold standard. Currency and credit were restricted, the bank rate was put up to 6 per cent in November 1919 and to 7 per cent in April 1920, and at the same period the public activities of the Government were greatly curtailed and the budgets strictly balanced. All the tools were being worked for one end and a mighty fall in prices¹ was brought about. Industry declined and unemployment showed itself. Similar tools were used in the United States and similar results were manifested.

During the same time in France and Central Europe an entirely different policy was being pursued. Budgets were not balanced out of taxation and money was accordingly borrowed for the purpose of making up the deficiency which the activities of the Governments created. Further credit and currency were abundant. On the other hand, bank rates were high. The majority of the tools and the most important of them were being used in a way that pointed to an increase in the price level; and increases took place everywhere. In France a moderate increase corresponded to moderate use of

¹ The wholesale index in Britain fell from 379 in March 1920 to 224 in April 1921.

the tools, in Central Europe a vast increase occurred owing to extravagant¹ use.

In 1922 both in England and in America there was some change in policy; bank rates were lowered and the restriction of credit was partially lifted, other factors remaining the same. Prices ceased to fall; and in the U.S.A. some increase took place, bringing with it a recovery of trade. In the autumn of 1924, however, the Bank of England made a further drive by restricting credit and thus produced a further fall in prices and a further slump in industry. This policy was not imitated in the U.S.A. and prices remained there on an even keel and trade good. The effect of this was to make the "pound look the dollar in the face" on the old level of \$4.86 to £1, and the British Government restored the gold standard, and thence-forward until 1931 prices in terms of pounds were clamped to prices in terms of gold. That is to say, that as the pound was declared by law to be the equivalent of a little more than $\frac{1}{2}$ oz. of gold, an article such as a ton of steel which exchanged on a certain date for an ounce of gold cost approximately £4.

Meanwhile France continued the expansionist policy for some little time longer, and the price level rose higher and higher; and the French franc fell more and more in terms of the dollar and the pound. She then revised her monetary policy, restricting credit and Government expenditure and increasing

¹ See, however, page 47.

taxation. This stopped the rapid rise in prices and raised the exchange value of the franc. She then returned to the gold standard on a new basis.

The Central European countries, who were weighted down with foreign debts, did not revise their policies until their currencies had gone to practically nothing and something like chaos had been created in their internal affairs. They then made a fresh start with debts considerably scaled down and with new currencies on a new gold basis.

This empirical illustration is not of course conclusive in proving the efficacy of the tools in question. But few people to-day question the power of the Government and the Bank between them to reduce the price level in a country not on the gold standard, if they use the tools in their possession sufficiently drastically. And if there are any people who doubt the power to put up prices in a similar country I would remind them that if it were not so the Government would have a short cut to universal popularity. It could remit all taxation, spend lavishly, and do it all by borrowing and expanding credit. The reason why this would be disastrous policy is only because the inevitable consequence of this inflation would be a rapid rise of prices.

CHAPTER VIII

OSCILLATIONS

THE argument of the preceding chapter has been devoted to showing that there are effective tools in the hands of Governments and banks for raising or lowering the price level, and that leaving out of account impossible debts, wars, and other cataclysmic events, these tools are likely to prove strong enough to reverse upward or downward movements in the price level by whatever agency they may be caused. But it is important to realise that this is not the same thing as saying that the price level can be kept stationary, or, in other words, that the group of goods described in Chapters IV and V can be made always to exchange for precisely one monetary unit. They can stop long-continued trends in one direction, but can they stop oscillations?

When a country is strictly on the gold standard the Central Bank keeps a reserve of gold, and anyone possessing currency can go to the Bank and exchange it for gold or vice versa. So long therefore as this reserve does not run dry the unit of value remains clamped to a fixed weight of gold. The Bank need not worry about the precise amount of gold entering or leaving the reserve on a particular day, provided that it is satisfied that over a period of time the outflow will be met by the inflow.

But there can be no such reservoir to even things out when it is desired that the unit of value shall be linked not to gold but to the hypothetical group of goods. The composite price of the group may show signs of rising, and the tools may at once be applied to bring it down. But it does not follow that their action will be instantaneous. An interval of time may elapse and, during this interval, outside disturbing factors may carry the price considerably higher. Then when the tools at last do their work and the price begins to fall the momentum and possibly other disturbing factors may carry the price down below the point of equilibrium. Thus it is possible that oscillations may be produced instead of rest.

The point will perhaps be best appreciated by means of an analogy. Many steam engines have attached to them what is called a "governor," the object of which is to oblige them to run at a constant speed. It operates by throttling down the inflow of steam when the engine begins to run too fast, and by opening it out when the engine runs too slow. With a perfectly running governor absolute uniformity of speed is attained. But if the action of the governor were to be delayed, the engine would get up too much speed before it began to be slowed down, and would lose too much before it began to be accelerated; and oscillations of speed would take place.

In the monetary problem the question is how rapidly will the tools act in counteracting the

disturbing factors which are throwing the smooth running out of equilibrium. Consider first of all the use of the tools in stopping a rise in the price level. Without any delay the bank rate can be put up, steps can be begun to restrict credit and reduce currency and at the same time influence can be brought to bear to restrict new private ventures. Government action in curtailing its activities cannot by the nature of things be taken so promptly, but unless the Government is engaged in war or some other colossal undertaking or has to meet some very heavy foreign claims it can do so after a little while; or alternatively it can raise a larger part of the necessary money by taxation, which will have nearly the same effect. The combined action of all these tools will therefore be that, in the early future, purchasing power will be reduced and prices lowered; and the knowledge that this is inevitably going to take place will have an immediate psychological effect on the market and the interval between bringing the tools into play and the reversal of the upward movement of prices will not be very long.

The opposite process of reversing a fall is governed by slightly different considerations. It is true that there need be equally no delay in bank-rate reductions, in widening the basis of credit, and in bringing influence to bear. But these will not produce any extension of private activity or increase of purchasing power or rise of prices unless the credit available on the new basis is actually taken up. If, therefore, it is

not, it is essential that the other tool of increase in Government activity without increase of taxation be brought into play at the earliest moment.

Incidentally this explains why it is that at the present time (January 1933) with a low bank rate, credit restrictions slightly relaxed, and some outside factors tending to promote a rise, no upward movement of British prices is in fact taking place; for so far from extending its activities the British Government is drastically curtailing them.

In the general case, however, if in addition to the use of the other tools the Government takes action to expand activity it will by so doing set in motion an upward tendency; and the interval between the decision to apply all these tools and the result will largely depend on how rapidly the Government's decision is implemented. But here also if the Government's policy is clearly indicated at the start, and if experience has shown that it has been effective in the past, the psychological factor will operate and the downward movement is likely to be checked much earlier than would otherwise be the case.

Time alone will show to what extent these oscillations can be reduced or even obliterated. Central bankers have acquired a very considerable technique which they use skilfully enough in promoting the objects which they at present set themselves to accomplish. If in future the financial Authorities apply their knowledge and experience to creating a new technique with the object of

keeping the unit of currency of a country closely linked to such a representative group of articles as I have suggested, there is no reason to doubt that they will be able to attain a considerable measure of success in damping down the oscillations to which disturbing factors are likely to give rise.

CHAPTER IX

THE SYSTEM AT WORK

THERE is an essential difference between the system which exists to-day and the new system which it is proposed to substitute for it. Under the existing system the whole production of the twentieth-century world has to pass through the bottle neck of a nineteenth-century financial apparatus. Under the new system the needs of an expanding production will be met by appropriate new financial machinery. Finance will then become, as it should be, the servant and not the master of the world's economy.

Under the present system the counters are constantly changing their value, so that a man's real income depends not only on the number of them which he receives but on their value at the time. Under the new system the counters will have a stable value and his income will depend solely on their number. If life were a series of episodes the distinction would make no serious difference. But in fact life is a chain of events each linked to the one preceding it; and contracts of all kinds are carried forward right along the chain. In these circumstances the distinction is vital.

Many financial authorities who have been in the habit of working the old system regard the new one as revolutionary and pregnant with disastrous con-

sequences. They have been so used to shutting down production whenever it showed signs of rapid expansion that they fear if the means to do so is taken away from them over-production is certain to occur.

On the other hand, there are others, critics of the present system, who believe that there is inherently at all times a lack of purchasing power in the community and who desire to rectify this state of things by continually pumping in additional purchasing power and expanding credit.

The proposals of this book are based on the view that it is only at times that purchasing power is insufficient and that there may even be times when it is redundant. These times are clearly indicated by movements in the general level of prices. The system here advocated would work by pumping in additional purchasing power when the first incipient signs appeared of a fall in the price of the group of goods below normal, and of withdrawing purchasing power if it should ever happen that the price began to rise above it.

To illustrate its working, I will take first the case of a disturbance in the even flow of manufacture and trade occasioned by the discovery of some new process in the production of commodity A. As a result I will suppose that the producers of A find that whereas hitherto they have been in the habit of turning out x units of A per day, they are now able to produce $x + y$ units with the same labour at the same cost.

The first effects of this change will be identical under the old system of a currency linked to gold and under the new. For a short time the producers of A will make increased profits. Then the law of supply and demand will operate and the price of A will begin to fall.

It may very likely be the case that in the general conditions then prevailing no wide additional demand¹ for A will show itself even when the price is reduced. If so, the producers of A will find stocks of it accumulating on their hands and will keep on reducing its price. In the end they will be forced to cut down output to the amount which the market will take, which may be not much above the original x . As a result plant will not be working up to full capacity and men will be thrown out of employment.

These consequences are unfortunate, but they are to some extent inevitable in a changing world. For though there has never been and is never likely to be for a long time to come genuine over-production all round, there has often been and will certainly be again in the future disproportionate production. When this shows itself adjustment cannot be avoided. The form this adjustment takes will, however, depend largely on the financial system; and there

¹ This is what economists call an "inelastic" demand, and the argument in the text is for brevity confined to that. The other case of an "elastic" demand leads to slightly different results, but in this also the new system would prove the better.

will be an essential difference in the consequences to the community as a whole and to the persons thrown out of employment whether the currency is tied to gold or whether it is based on the new system.

Under the gold system there will be no alleviating circumstances. The increased purchasing power left in the hands of the purchasers of A owing to its fall in price will be offset by the loss in earnings of the producers of A, and so little or no new stimulus will be given to the production of other things. There is no reason to suppose, therefore, that the men thrown out will find other employment.

Under the new system, on the other hand, the first signs that the price of A is falling, dragging downwards with it the general price level, will be a signal to put into operation the necessary financial machinery for expansion. This will provide a stimulus to the production of other things. This stimulus will tend to grow as the price of A falls. In consequence the men thrown out of A will be re-engaged to produce B, C, D, etc., and profits and wages in these occupations will rise. To some slight extent also the restoration of prices may even result in some increase in production of A; this is merely the financial aspect of the obvious economic truth which is illustrated by the fact that if more houses are being built people will want more furniture.

It may perhaps be thought that the effect on the general price level of a change in the price of A will be too small to set in motion the important sequence

of events described above. This might be so if A was an insignificant item in the world's economy and the discovery of improved processes was confined to it alone. But when it is realised that at the same time similar discoveries are affecting the production of many articles which between them account for a substantial part of human activity this fear will be seen to be unfounded.

Let us now turn to a disturbance of a different kind. I will suppose that one country has adopted the new system and is working it, but that other countries are still on the gold basis. I will suppose that those other countries experience a fall in prices, including those of articles which are the subject of international commerce. How will the country on the new system continue to preserve its equilibrium in the face of this foreign disturbance?

In the first place the country will feel the effects of what is happening (just as it does at present) through a fall in the price of its imports and in the fall in price of foreign goods with which its own exports have to compete. This will affect all home industries which are subject to foreign competition—the unsheltered trades, as they are often called—and prices in all these will tend to fall inside the country. That will tend to bring down the general price level and will be a signal to apply the necessary financial expansion. This will provide a stimulus to the sheltered trades. It will also bring about an alteration in the rate of exchange, to the advantage

of exporters and of the home competitors of imports from abroad. So that the restoration of the price level and the re-establishment of industry will come about partly through providing a stimulus to the sheltered and partly by giving help to the unsheltered trades.

A numerical example may perhaps make the position clear. Suppose that prices abroad fall 10 per cent. Suppose that articles of international kind produced by the unsheltered industries account for one-half of the "basket," while the products of the sheltered trades account for the other half of the "basket." Then it will be found that when equilibrium has again been reached the exchange value of the currency of the country based on gold will have fallen 5 per cent, and there will be this amount of relief to the unsheltered industries, and that the internal price level of the sheltered products will have risen 5 per cent, providing them with this measure of stimulus.

This result may be contrasted with that which prevails at present with two countries both on the gold standard. In that case a fall of prices in one country produces on the other country an unmitigated depressing influence. The unskilled trades receive no relief and the sheltered trades no stimulus, and the general level of prices of both taken together is reduced.

CHAPTER X

IMMEDIATE STEPS

As a foreword to this book I have quoted the text of two resolutions. The first was carried unanimously by the Labour Party at its Annual Conference at Leicester in October 1932; this repeated in substance a similar resolution carried at Scarborough the preceding year. The second was carried unanimously by the Conservative Party Conference at Blackpool, also in October 1932. It will be seen that these two resolutions are in essence the same. They both declare specifically that the aim of British monetary policy should be to stabilise British wholesale prices.

It has been the object of earlier chapters in this book to crystallise the policy thus advocated by two great parties in the State into a concrete system in which its implications can be carefully examined. There remains, however, the final problem of deciding on the immediate steps which the British Government ought to take if the system is to be brought into operation.

The first step is to make a declaration that the Government accepts as its objective the stabilisation of wholesale prices at a suitable level and that it has no intention (not even in consideration of cancellation of the British Debt to America) of returning to

the gold standard, at any parity, under anything like the old system. The value of this declaration would be that it would give an assurance to manufacturers and traders which would greatly assist them in planning their future activity.

The second step is for the Government to revise its economy campaign and re-embark on such an amount of public activity as may be necessary to effect the desired initial adjustment. The increase of purchasing power which this will create is equally important with the rise of wholesale prices which will accompany it, for with greater output industry will find the burden of overhead charges less onerous. At present there is much credit lying unused; so that though some further expansion of it may be required, very likely this will not be necessary. If proper precautions are taken the effect on retail prices should be small and may even be non-existent.

The third step for the Government is to procure the repeal of the present limit on the fiduciary¹ issue. This is not because the number of notes at present in circulation is pressing hard on the legal maximum or that Government policy would result in any sudden large increase. But the limit is really an out-of-date survival of the time when England was on a gold basis, and its continuance hampers the Government in its full use for international purposes of the gold reserve at the Bank.

The fourth step is to survey the whole range of

¹ That is the amount of bank notes uncovered by gold.

wholesale goods in order to discover the best group to be included in what I have called the "basket." This should not be entrusted to a Royal Commission, which would take too long. A departmental committee, taking expert advice and with the experience of existing index numbers in mind, could produce an exhaustive report in a very few weeks. This report ought to set out separately the best groups to choose according as the solution was expected to be (a) international or (b) domestic.

The fifth step is for the Government to prepare and place before the World Economic Conference a proposal for linking the currencies of the world to the international group of commodities recommended by the committee proposed in the last paragraph as suitable for an international solution. If the World Economic Conference is over before the Government makes up its mind to this course, then the Government should invite a new Conference for the express purpose of considering this scheme.

The next step will depend on what the attitude of the other principal Governments is to the British proposal. If there are signs of a desire to co-operate every opportunity should be given for them to do so even if this means some delay in bringing the scheme into operation and some modification of the scheme itself or in the group of things selected. But, important as it is to secure international co-operation and thereby to avoid fluctuating exchanges, there must be no sacrifice of the fundamental principle of the

scheme, which is the stabilisation of wholesale prices. Otherwise the world may be back on the shifting sands of a falling price level with its consequent misery and disaster.

With this reservation, however, there is nothing to prevent the use of gold to some extent for the purpose of settling international liabilities. But this can only be so provided that there is a workable solution of the debt problem and that the yearly ings and outgoings of nations are capable of being made to balance by the normal operations of trade.

If, on the other hand, at the International Conference there is no sign of general agreement with the proposal, then this country will have to act alone or with the support only of those countries which are disposed to give it. At the present time most of the British Empire and several countries in Europe have elected to relate their currencies to the British pound sterling, and there is every reason to think that they would continue to do so if the policy of this country were declared on the lines indicated.

The case of Sweden is particularly interesting because it has ever since October 1931 been endeavouring with a wide measure of success to promote a policy¹ of this kind. In January 1932 the Finance Minister gave his approval to "preserving the internal purchasing power of the krone," and in the following month the Riksbank (the Swedish

¹ See the *Midland Bank Review* for October–November 1932.

national Bank) declared that "The Riksbank's intention is to endeavour to maintain more or less unaltered the average level of prices of home-market goods and of the most important services that form an integral part of consumption."

The British Government is therefore assured in advance of some co-operation in carrying out such a policy. It will then have finally to decide on the best group of commodities to select and to what extent the state of industry and employment require any further adjustment of the price level before it is stabilised. It ought to be guided in these decisions mainly by the domestic needs of this country, but should pay some attention to the probable effects on the countries which are likely to co-operate with it.

The final step will then be for the Government to bring the whole policy into immediate operation. Simultaneously it should make another declaration of policy similar to the first, but much more precise and definite, explaining exactly what is the group it is going to stabilise and the general effect of stabilisation. It should also make it abundantly clear that the whole strength of the Government and the Bank will be directed to preserving the price level in this way, and that neither exchange fluctuations nor speculative forces will deflect it from its course.

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CHAPTER XI

REPLIES TO QUESTIONS

1. *What is the essential element of the scheme?*

To stabilise a representative group of wholesale prices at a suitable level.

2. *Can this be put into operation by a single country or must it be done internationally?*

It would be much better to do it through a common policy agreed by all nations. But failing this it can be done by one country alone.

3. *Can a single country successfully operate it?*

Yes, though, if the country were small, only with difficulty. But for a country such as Britain with a great Empire behind it and many other countries inclined to co-operate there is no difficulty which could not be satisfactorily surmounted.

4. *Will not the instability of the foreign exchanges be in that case a serious inconvenience?*

Yes. But it is a lesser evil than instability in the level of prices. It must be remembered that stability in the exchanges has already disappeared and the only way to restore it (short of international agreement on new lines) would be to return to the gold standard which worked so disastrously in the past.

5. *Does the scheme involve any new departure in British policy?*

Yes, the economy campaign must be completely

revised; and public activity and public credit must be used for first adjusting the price level and then stabilising it.

6. Does this require the support of the Bank of England?

Yes. Government and Bank policies must be completely co-ordinated. The Bank must therefore come under the control of the Government.

7. Is there any reason to expect any immediate relief to British industry?

Yes. Because the expansion of credit and the promotion of public activity will increase purchasing power and raise wholesale prices. The gain to industry will therefore be far greater than the mere employment provided directly by the Government undertakings.

8. How will the increase in prices help the manufacturer?

In rising it will provide him with a stimulus and when the rise has taken place it will reduce the effective burden of his overhead charges.

9. Will not the increase in prices necessarily injure the export trade?

No. Because it will apply equally throughout the area where the scheme is in operation, and outside that it is likely to be adjusted through a fall in the exchange.

10. How will the scheme help labour?

By substantially increasing employment.

11. Will not the rise in prices be detrimental to real wages?

Not unless it includes a rise in retail prices. Even if this occurs at all it is likely to be much less in

proportion and can easily be corrected through an equivalent rise in money wages, which will still leave the manufacturer better off.

12. Will industry obtain lasting benefit?

Yes. Because producers will have the assurance that they can count upon a steady purchasing power of money, and that the trade cycle with its booms and slumps—children of fluctuating prices—has been dealt a mortal blow. But if the area in which the scheme is in operation remains limited the benefit will be limited too because the continued depression of the rest of the world cannot fail to have an injurious effect all round.

13. Will the scheme raise the standard of life of the people?

Yes. Because it is the present system which defeats the claims of the workers. Profits are skimmed off in times of prosperity, and wages are forced down and unemployment created in times of depression. Of a steady rising tide of material wealth the working producer will be able if well organised to secure the major share.

14. In the event of a change in the economic structure of society would the scheme continue to work?

Under full socialism the ordinary working of the laws of supply and demand would be greatly modified. But it would still be highly desirable that the unit of value should preserve stability; and the wide control of production by the Government would make this more easy.

15. Will the scheme restore and guarantee the prosperity of the world?

No one but a fool will prophesy the millennium. Impossible international debts and an irrational system of finance have so dammed up the stream of human progress that the waters turned back upon themselves have created a flood which has nearly swept civilisation away. The most that I claim for the present proposals is that they will remove one of the great obstacles. If at the same time the burden of international debts is also removed, a chance will be provided for the waters to flow down again through their normal channels; and the economic landmarks will begin to show themselves again. With their reappearance humanity will be forced to face up to other problems—the insistent need to plan the whole of economic life and to establish mutual goodwill through a juster distribution of wealth. On these matters I hold strong convictions, but they raise issues which I must not pursue further here, for they would lead me into controversial paths in which I might perhaps lose some of the friends whom I have made through the pages of this book.



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